British Columbia Railway Group Annual Report for 1988

Corporate Statement

The British Columbia Railway group comprises three companies:

- ☐ British Columbia Railway Company, which holds investments in its two subsidiary companies
- ☐ BCR Properties Ltd., which owns and manages the group's non-operating real estate assets and
- ☐ BC Rail Ltd., which is the group's railway operating company.

The Province of British Columbia is the sole shareholder of British Columbia Railway Company, which holds 100 per cent of the common shares of BCR Properties Ltd. BCR Properties Ltd. owns 75 per cent of the common shares of BC Rail Ltd., the remaining 25 per cent of which are held by British Columbia Railway Company.

In addition, $200 million of non-voting, Series 1-A Preferred Shares were issued by BC Rail Ltd. on Canadian stock exchanges in 1984, at a unit price of $25 per share.

The railway's principal sources of revenue are the transportation of forest industry-related products and coal from British Columbia's northeastern coalfields. In recent years, the company has also become active in marketing surplus landholdings and telecommunications capacity.

The railway operates 1,390 miles of main track between North Vancouver and Fort Nelson, B.C. and has connections to all rail-served points in North America. Group assets exceed $1.3 billion.

Cover: Southbound at West Vancouver, B.C.

Track maintenance in North Vancouver yard.

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Financial Highlights

	(Dollars in Thousands)	
	1988	1987
Operating revenues	**$326,994**	$325,597
Operating expenses	**$242,709**	$244,787
Operating income	**$ 84,285**	$ 80,810
Net income before minority interest	**$ 76,816**	$ 72,755
Net income	**$ 58,316**	$ 54,255
Carloadings	**225,971**	233,162
Total tons of freight hauled	**17,340,000**	17,670,000
Employees at year-end	**2,700**	2,760

Board of Directors

Gerry Strongman, Chairman
Victor Bowman
Winton K. Derby
E. Beverly Ellis
Jim Inkster
Edward John
E. A. Moffat
M. C. Norris
James T. Rabbitt, M.L.A.

Officers

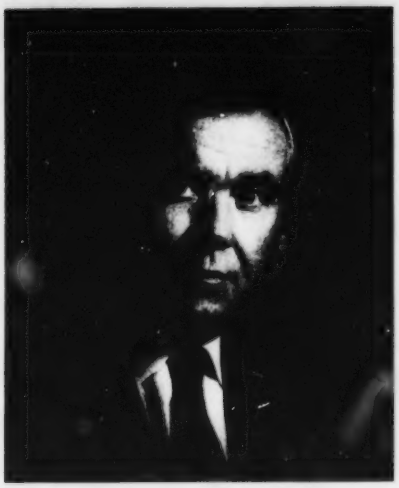
M. C. Norris, President and Chief Executive Officer

A. C. Sturgeon, Senior Vice-President — Operations and Maintenance, Marketing and Sales

J. R. Clarke, Vice-President — Finance and Administration

Brian Foley, Vice-President — Industrial Relations and Information Systems

R. W. Young, Corporate Secretary and General Manager — Real Estate Development



Chairman's Report

In almost every respect, 1988 was an active and successful year for the group and I am pleased that my first year as Chairman of the Board of Directors was marked by a further year of record net and operating income. Compared with the record losses experienced only a dozen years ago, the last seven years' results are a remarkable achievement and in no small way, a tribute to the leadership of President Mac Norris, his management team and the employees of BC Rail.

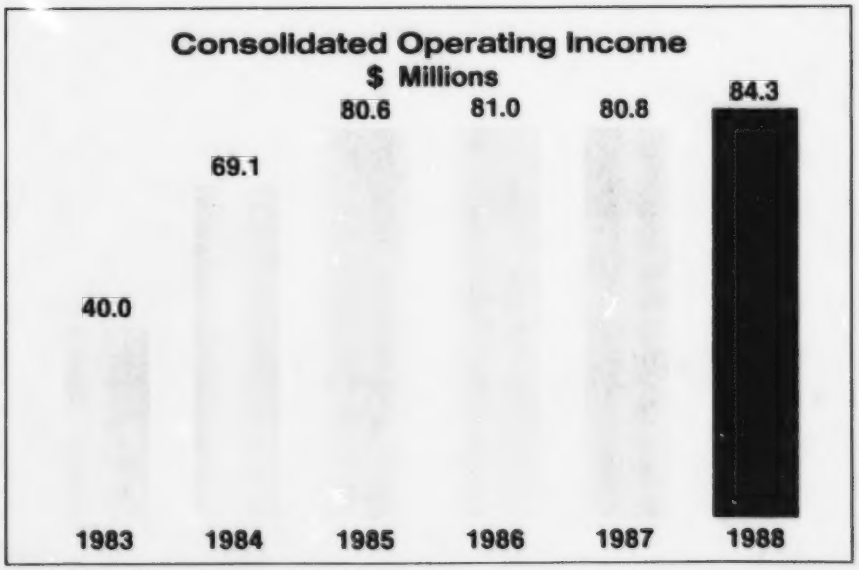
As Mr. Norris will report elsewhere, the coming year will bring changes to the management structure of the group, as the remaining members of his original executive management committee prepare for retirement. They, as well as those colleagues who already have left the company, have much to be proud of. I wish them well and on behalf of the Board and the Province, I thank them for the effort, knowledge and dedication they have given to the company during the challenging years of renewal.

Nineteen-eighty-eight was a year of learning for me, as well as for the other directors who joined the Board last year. In the seven or eight months of 1988 that remained after my appointment, I had many opportunities to speak to employees throughout the system and to study the railway's operations at first hand. Without exception, those I met at all levels have demonstrated loyalty, dedication and a desire to make the company as successful as it can be. The experience was rewarding and my knowledge of BC Rail and the industry in general was considerably enriched as a result.

The company continues to invest in modernization and renewal of the railway's physical assets and in the process, to make a very substantial contribution to the provincial economy. Last year's capital expenditures totalled more than $70 million while capital improvements for 1989 are projected at $95.2 million. The railway's payroll for 1988 stood at $114 million, including taxable benefits. Of approximately $100 million in materials and services purchases, $59 million was spent in B.C., $30 million elsewhere in Canada and $11 million in the United States and overseas.

During the 1989 operating year, the company will experience great change — a restructured executive group, a changing marketplace and perhaps a downturn in tonnage shipped. Nevertheless, I am optimistic. The company has always performed well during times of change and I am confident the men and women of BC Rail will rise to the challenges before them in the coming year.

Gerry Strongman,
Chairman



President's Report

It is very rewarding to report that net income for last year rose to $58.3 million, compared with the previous record of $54.3 million established in 1987.

Operating income also rose by approximately $4 million, from $80.8 million in 1987 to $84.3 million in 1988. Significantly, total carloadings for the year declined — an indication of increased productivity realized from the use of larger cars and improvements in lumber loading techniques.

The pleasure I have in reporting a seventh successive year of record operating results for 1988 is tempered somewhat by the knowledge that this year will see the retirement of yet another member of the original management team formed in 1975.

July, 1989, will bring to a close the distinguished railway career of my friend, colleague and senior vice-president, Arnold Sturgeon, who will be leaving the company after 44 years of service. Like former vice-presidents Gordon Ritchie — who retired last year — and the late Norman McPherson, who retired for reasons of ill health in 1985 — Arnold was one of the original members and indeed, the last remaining member of the senior management team I chose in 1975. In that respect, 1989 will mark the end of a management era for BC Rail.

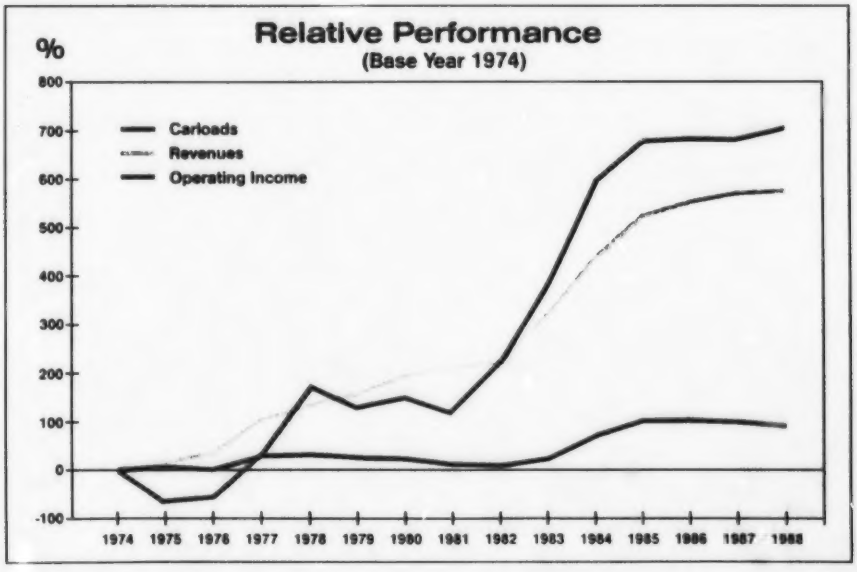
Today's BC Rail is a vastly different company to the one we took over in 1975 — and I am indebted to these and many other trusted colleagues for the loyalty and support they have provided over the years.

What seemed like an insurmountable task — the transformation of a demoralized and inefficient railway into the first class system it has become in recent years — was considerably lightened by the presence and counsel of Arnold, Gordon and Norman during these sometimes difficult, but always challenging and rewarding years of renewal.

Thirteen years ago, our fortunes were perhaps at their lowest ebb. Our financial picture for 1976 showed enormous losses of $53.4 million and as a company, it seemed, we simply lurched along from one crisis to the next.

Today, however, is a far cry from those days when heavy losses were the norm. Derailments then were at least a daily occurrence — and the company, so it seemed, was the unending object of editorial derision and political intervention.

If there is one area above all others, in which our management team can take pride, it is the regeneration of self-esteem and external respect that has taken place since we began working together more than a decade



ago. The renewal and modernization of physical plant may be more apparent. The restoration of pride in what we do and our determination to do it, however, was every bit as vital.

Undoubtedly, Mr. Justice Lloyd McKenzie's Royal Commission on the railway's affairs provided the stimulus for renewal and more than any other single occurrence, spelled out for our political masters the direction which, if it were to survive, the railway must take.

We are lastingly grateful to Mr. Justice McKenzie and his fellow commission members for their vision, and to our Board of Directors for their understanding and support, without which it might never have been possible for the management and employees of BC Rail to create the successful enterprise the company has become.

I am grateful too, to the many loyal and dedicated employees — as well as my colleagues in executive management — who have contributed, and continue to contribute to the success of the British Columbia Railway group of companies.

M. C. Norris, *President and Chief Executive Officer*

Northbound on Howe Sound.

The Year in Review

An expanding provincial economy, productivity improvements and major industrial development and expansion in the BC Rail operating area made a substantial contribution to the British Columbia Railway group's 1988 financial performance.

Last year was the seventh consecutive year for which the group has reported improvements in operating results, net income having exceeded 1987 net income by approximately $4 million or 7 per cent. Railway operating revenues in 1988 increased to $327 million, from $325.6 million the previous year.

After payment of dividends to preferred shareholders, group net income was a record $58.3 million against the former record of $54.3 million set in 1987. A dividend of $10.3 million was paid to the Province of British Columbia and dividends totalling $18.5 million were paid to the holders of BC Rail Ltd. preferred shares. No new borrowings were undertaken during the year. Existing long-term debt was reduced from $113.4 million to $111.5 million.

Major capital works continued during 1988 and included a $29 million continuous welded rail (CWR) installation between mileboards 264 and 350, to the south of Williams Lake. This brings the total length of CWR installed in the BC Rail system to 327 miles.

Additional investments were made in steel tie installations in areas of high curvature; upgrading of the Fort Nelson extension; bank-widening; rock stabilization and ballast and tie replacement programs elsewhere in the system.

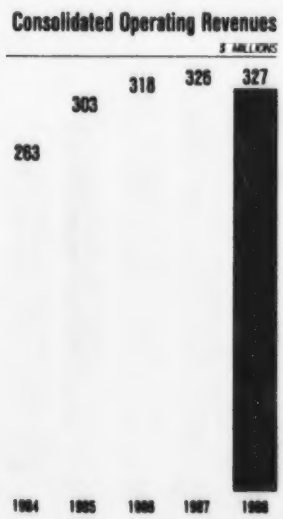
At year-end, a new 4,000-foot tunnel at Shalalth, approximately 16 miles south of Lillooet, was nearly complete, well under budget and nearly two months ahead of schedule. First trains through the tunnel were scheduled for mid-March, 1989. The official opening was to take place on April 11th.

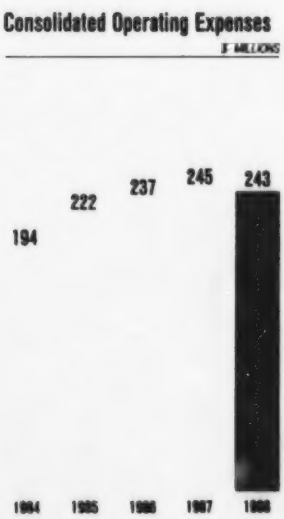
The new tunnel bypasses a troublesome section of line along the shore of Seton Lake, at the foot of Shalalth bluff. Unstable rock has long been a hazard in the area and during the last few years, a number of closures have been necessary as a result of rockslides. Construction began in March, 1988 following successful negotiations with the landowners the Seton Lake Indian Band.

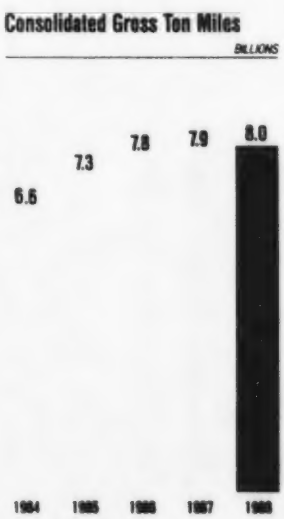
In efforts to capitalize on larger freight cars now available, BC Rail Ltd. took delivery of 160 seventy-three foot centrebeam bulkhead flatcars, purchased offshore in kit form, to replace a number of shorter cars which have since been leased to other North American carriers.

These Korean-made car kits were assembled by BC Rail employees in the Squamish repair facility and, as well as diverting work otherwise intended for the United States, the agreement with the U.S.-based importer offers tax savings and opportunities for further assembly work for other carriers.

Near year-end, management determined locomotive fleet renewal requirements and







as a result, announced orders for twenty-two, 4000 h.p. diesel-electric units. Of three tenders invited, the General Electric Company was successful and deliveries are expected to begin this fall. The 22 new locomotives will replace 29 older units to be disposed of through a trade-in agreement.

The total number of revenue freight cars hauled during the year declined by approximately three per cent — from 233,162 in 1987 to 225,971 — the result of improved lumber loading practices and the use of larger railcars. The productivity gains, however, were offset in tonnage terms by a prolonged labour dispute involving one of the railway's ore shippers. Tons hauled in 1988 were 17.3 million, against 17.7 million the previous year.

Traffic volume and profitability of intermodal or 'piggyback' services continue to increase and Motor Carrier Operating Authority obtained in 1988 paves the way for enhanced highway services for a variety of commodities. Planned development of intermodal facilities in 1989 will offer further operating efficiencies.

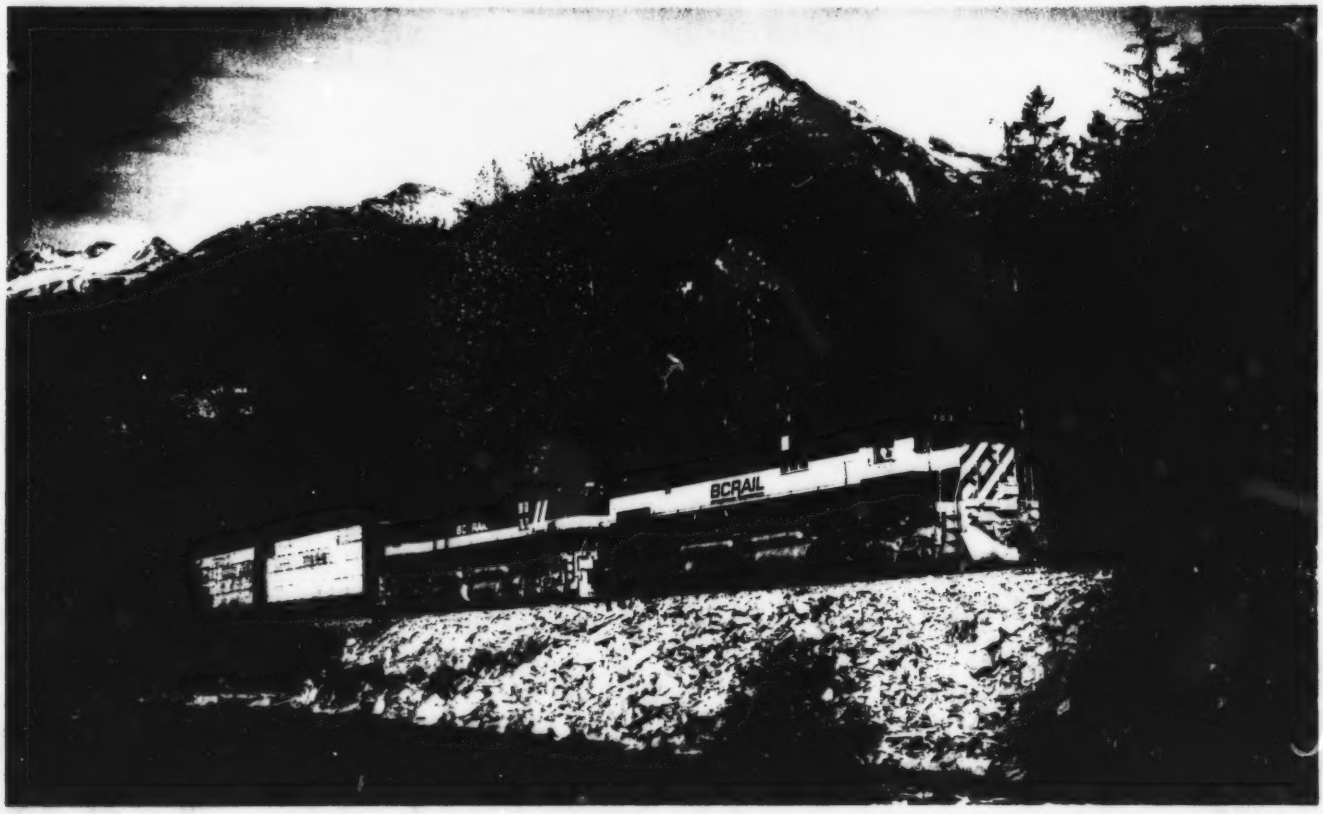
There is little doubt that the railway's performance in 1988 was spurred by British Columbia's improving economy. Encouraged by that and favourable world market conditions for provincial resources, a great deal of industrial development took place in 1988 in the railway operating area.

As well as the opening of a new newsprint mill in Mackenzie, B.C. — the first facility of its kind on the line — nine other shippers served by BC Rail invested more than $600 million in new or expanded pulp, sawmill, waferboard or other forest products manufacturing facilities.

Further south, an Australian-owned steel tie manufacturing plant is due to begin production in Squamish as a direct result of BC Rail's pioneering steel tie program. The plant's owners anticipate further North American steel tie sales as a result of BC Rail's favourable test and operating experience. The Squamish site was chosen for its proximity to the Pacific Rim, tidewater and the BC Rail line.

The railway's experience in B.C.'s northeastern coalfields was again favourable in 1988 and earnings from the carriage of coal

Export lumber, Wedge, British Columbia.



continue to be a major contributor to overall revenues. Like other participants in the project, BC Rail is optimistic about the outcome of recent arbitration hearings concerning the price of northeast coal and confident that its substantial investment is not endangered.

BC Rail's Cariboo Dayliner passenger service continues to earn acclaim from around the world and a successful summertime experiment to operate daily service to and from Prince George — normally operated only three times weekly — will be repeated in 1989. Intensified marketing efforts led to a 21 per cent increase in ridership during the year. Enhanced on-board service and a completely refurbished fleet of cars are contributing to the success and development of the service.

Initiatives to foster better relationships with the Council of Trade Unions on BC Rail were undertaken and regular union-management meetings have been established to deal with emerging issues. Results are encouraging and in some instances, potential problems are being resolved before they become serious matters of contention. The railway's strike-free reputation since 1980 continues with the cooperation of its unionized employees. Current collective agreements with the seven-member union council expire in June, 1990.

At year-end, plans for management-employee meetings to explain pension fund diversification were well under way and senior finance and compensation managers began travelling through the system early in 1989.

Investment diversification of the pension fund is intended to provide an improved return on funds invested and minimize investment risk.

Continued efforts to obtain approval for expansion of commercial telecommunications services proved unsuccessful. In the meantime, engineering for a proposed upgrading of the railway's microwave system is under way.

Implementation of an information resource plan for dataprocessing services continued and a 'customer marketplace' project is close to completion. This project will provide better information to various departments on customer requirements and the use of communications and freight services.

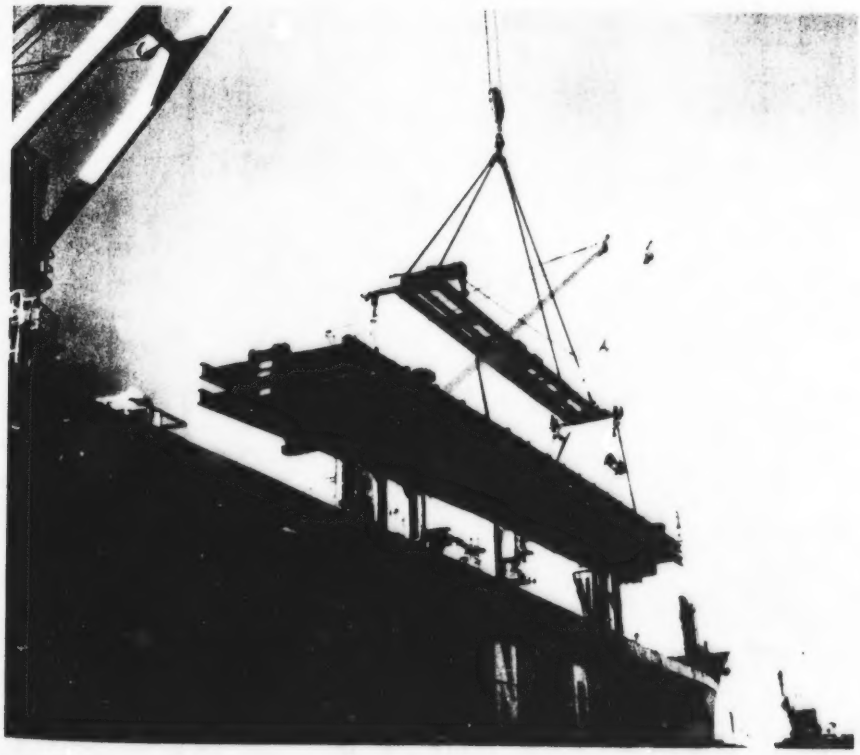
International Rail Consultants, a joint venture with Sandwell Swan Wooster Ltd., provided technical assistance in Mozambique and Venezuela during the year and at year-end, approval for proposed projects in southern Africa and Bangladesh was obtained from the Canadian International Development Agency (CIDA). International Rail is in its fourth year of operation. A number of projects are set to begin in 1989.

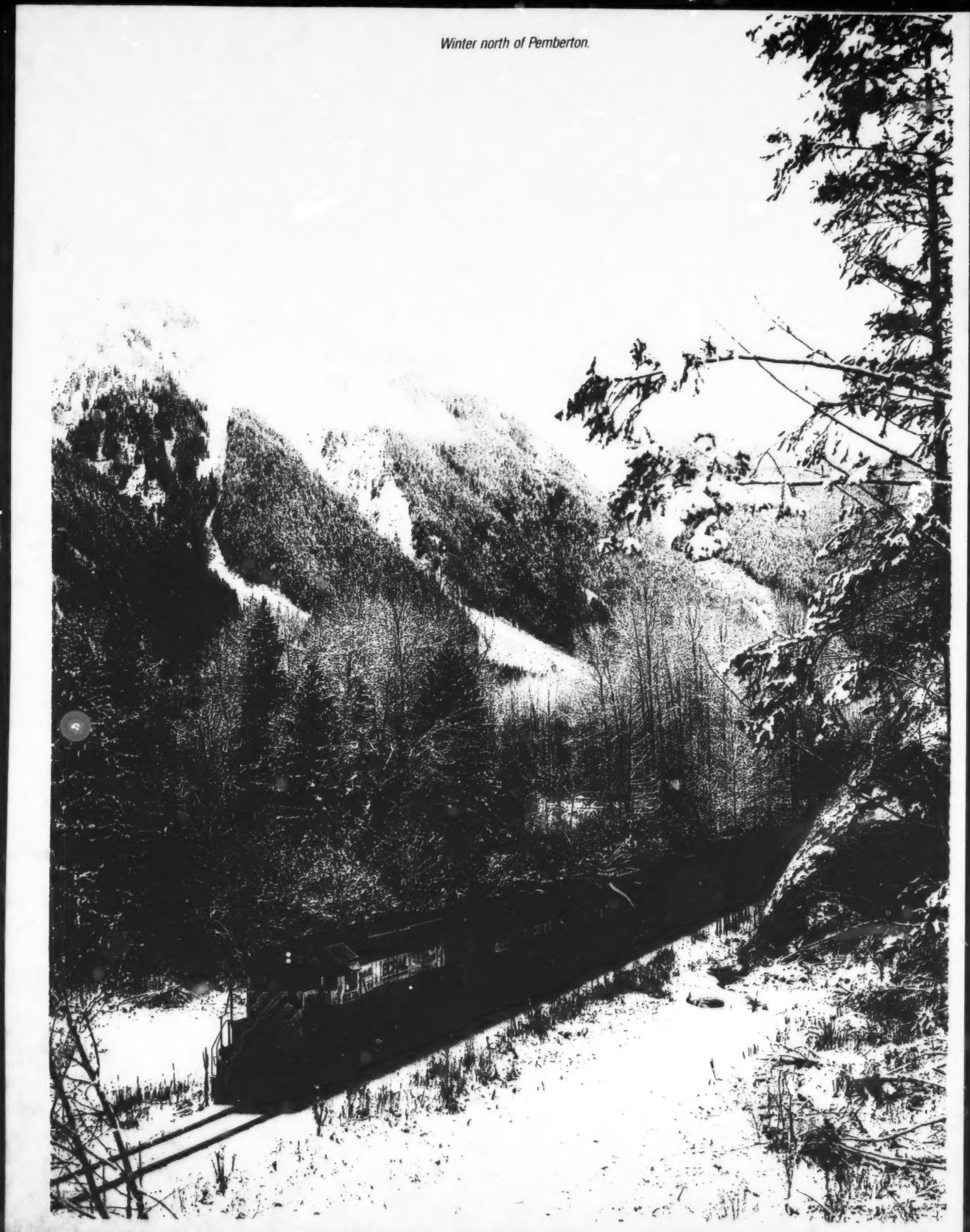
Employee participation in the company's suggestions and employee assistance programs continued at traditional levels, as did efforts to increase employee awareness and support for the services.

Office services functions were integrated with the personnel services function and in the latter department, special attention was paid to performance appraisal systems to ensure uniform application of standards and guidelines. A career counselling service was launched during 1988 and at year-end, a large number of employees had taken advantage of the facilities offered.

Since the formation of its property administration and development subsidiary, BCR Properties Ltd., the group has been playing an increasingly active role in the sale, lease and development of marketable lands with encouraging results.

Unloading Korean car kits in North Vancouver.





Winter north of Pemberton.

British Columbia Railway Company
Consolidated
Financial Statements

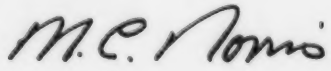
British Columbia Railway Company Report of Management

The accompanying consolidated financial statements of British Columbia Railway Company and all other information contained in the Annual Report are the responsibility of management. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances in a manner consistent with the previous year and, accordingly, include some amounts based on management's best judgements and estimates. The financial information contained elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

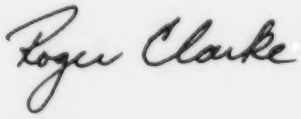
Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance, at an appropriate cost/benefit relationship, that assets are safeguarded and that transactions are authorized, recorded and reported properly. The internal accounting control system is augmented by a program of internal audits and appropriate reviews by management, written policies and guidelines and a written Code of Business Conduct adopted by the Board of Directors, applicable to all employees of the company. Management believes that the company's internal accounting controls provide reasonable assurance that assets are safeguarded against material loss from unauthorized use or disposition and that the financial records are reliable for preparing financial statements and other data and maintaining accountability for assets.

The Audit and Finance Committee of the Board of Directors, composed solely of directors who are not officers of the company, meets with the independent auditors, management and internal auditors periodically to discuss internal accounting controls, auditing and financial reporting matters. The committee reviews with the independent auditors the scope and results of the audit effort. The committee also meets with the independent auditors without management present to ensure that the independent auditors have free access to the committee. The committee reviews the annual financial statements and recommends their approval by the Board of Directors.

The independent auditors, Coopers & Lybrand, are appointed by the Lieutenant Governor in Council to examine the financial statements of British Columbia Railway Company and conduct such tests and related procedures as they deem necessary in conformity with generally accepted auditing standards. The opinion of the independent auditors, based upon their examination of the financial statements, is contained in this Annual Report.



M. C. Norris,
President and Chief Executive Officer



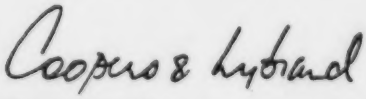
J. R. Clarke,
Vice-President,
Finance & Administration

Auditors' Report

To the Lieutenant Governor in Council
Province of British Columbia

We have examined the consolidated balance sheet of British Columbia Railway Company as at December 31, 1988 and the statements of income and retained earnings and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1988 and the results of its operations and the changes in its cash position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.



Vancouver, Canada
February 9, 1989

British Columbia Railway Company Consolidated Income and Retained Earnings

(Dollars in Thousands)

For the year ended December 31	**1988**	1987
Revenues		
Rail operations	**$319,710**	$315,707
Government operating assistance — Note 9	**7,284**	9,890
	326,994	325,597
Expenses		
Operations	**70,674**	71,216
Equipment	**66,580**	67,042
Road	**45,516**	48,117
Depreciation	**35,853**	34,870
General and administration	**24,086**	23,542
	242,709	244,787
Railway operating income	**84,285**	80,810
Non-operating income (expense)		
Interest — Note 10	**(11,145)**	(11,839)
Other income	**3,676**	3,267
	(7,469)	(8,572)
Net income before deferred income taxes	**76,816**	72,238
Recovery of deferred income taxes — Note 8	**0**	517
Net income before minority interest	**76,816**	72,755
Minority interest	**18,500**	18,500
Net income	**58,316**	54,255
Retained earnings, beginning of year	**128,006**	84,059
	186,322	138,314
Dividends paid	**10,308**	10,308
Retained earnings, end of year	**$176,014**	$128,006

British Columbia Railway Company Consolidated Balance Sheet

(Dollars in Thousands)

December 31	1988	1987
Assets		
Current assets		
Cash	**$ 22,693**	$ 23,447
Accounts receivable	**38,441**	37,131
Material and other items	**33,747**	35,604
	94,881	96,182
Property and equipment		
Road and buildings	**1,182,069**	1,124,824
Equipment	**271,636**	269,943
	1,453,705	1,394,767
Accumulated depreciation	**308,535**	278,099
	1,145,170	1,116,668
Dease Lake extension — Note 2	**98,020**	98,020
	$1,338,071	$1,310,870
Liabilities and Shareholder's Equity		
Current liabilities		
Accounts payable	**$ 80,427**	$ 99,498
Current obligations on long-term debt	**1,766**	1,596
	82,193	101,094
Long-term debt — Note 3	**111,460**	113,366
Minority interest — Note 4	**200,000**	200,000
Shareholder's equity		
Share capital — Note 5	**257,688**	257,688
Contributed surplus	**510,716**	510,716
Retained earnings	**176,014**	128,006
	944,418	896,410
Commitments — Note 6		
Contingent liabilities — Note 7		
	$1,338,071	$1,310,870

On behalf of the Board

E. Beverly Ellis, *Director*

M.C. Norris, *Director*

British Columbia Railway Company Consolidated Cash Flow

(Dollars in Thousands)

For the year ended December 31	1988	1987
Operating activities		
Net income	**$ 58,316**	$ 54,255
Add (deduct)		
Items not affecting working capital		
Depreciation	**35,853**	34,870
Deferred income taxes (recovery)	**0**	(517)
Net changes in non-cash working capital		
Accounts receivable	**(1,310)**	13,896
Material and other items	**1,857**	(5,153)
Accounts payable	**(18,526)**	16,201
Interest	**11,145**	11,839
Minority interest in earnings	**18,500**	18,500
	105,835	143,891
Investing activities		
Additions to property and equipment	**(69,851)**	(72,447)
Change in payables for equipment purchases	**(545)**	(146)
Government assistance for capital items	**5,496**	4,343
	(64,900)	(68,250)
Financing activities		
Repayment of long-term debt	**(1,736)**	(12,259)
Interest	**(11,145)**	(11,839)
Minority interest in earnings	**(18,500)**	(18,500)
	(31,381)	(42,598)
Dividends paid	**(10,308)**	(10,308)
Increase (decrease) in cash	**(754)**	22,735
Cash, beginning of year	**23,447**	712
Cash, end of year	**$ 22,693**	$ 23,447

British Columbia Railway Company
Notes to Consolidated Financial Statements

1. SIGNIFICANT ACCOUNTING POLICIES

The accounting regulations prescribed by the Canadian Transport Commission for Canadian railways have been adopted to the extent that this is possible without submitting specific accounting policies and depreciation rates to the Commission for approval.

Basis of consolidation

The consolidated financial statements include the accounts of British Columbia Railway Company and its subsidiaries BC Rail Ltd. and BCR Properties Ltd. In these notes "company" refers to British Columbia Railway Company and its subsidiaries. All significant inter-company transactions are eliminated.

Class of business

The company provides a fully integrated rail freight service within British Columbia. Services other than hauling freight are not of sufficient size to warrant separate reporting.

Road property

New construction is recorded at cost net of Government grants. Abandoned or relocated sections are removed at average unit costs. Elements of track structure installed during planned programs are recorded at cost and the material replaced is removed at amounts which approximate average unit costs. Labour costs for programmed replacements are expensed as incurred.

Depreciation

Depreciation is provided for major categories of property and equipment on the straight-line basis at composite rates estimated to reduce the original cost to estimated salvage value over the average service lives of the classes. The group method is used for recording depreciation under which, on disposal, the original cost of assets retired less salvage value is charged against accumulated depreciation. No gain or loss on retirements, other than on accidental destruction of rolling stock and on disposal of land, is included in income. The original cost of assets less estimated salvage value is depreciated over the following number of years:

	Number of years
Grade and tunnels	100
Rail	35
Ties	15
Ballast	25
Bridges	30 - 80
Locomotives and power units	25
Freight cars	15 - 33

Repairs

Repairs and non-programmed replacements of track structure are charged against current operations. Betterments and major track relocations are capitalized.

Material and supplies

Inventories of material and supplies are valued at the lower of average cost and net realizable value.

Government assistance

Grants directly related to the construction or rehabilitation of road property have offset related road property capital expenditures. Operating assistance has been deducted from the related expense accounts or included in revenue.

Income taxes

Income tax expense is computed on the basis of accounting income recorded by BC Rail Ltd.

Transactions in foreign currency

Transactions originating in foreign currency are translated at the approximate exchange rates prevailing at the dates of the transactions. Assets and liabilities denominated in foreign currency at the balance sheet date are translated to equivalent Canadian amounts at the current rate of exchange.

Leases

Certain long-term lease transactions relating to the financing of equipment are accounted for as purchases. The capital lease obligations reflect the present value of future minimum rental payments discounted at the interest rate implicit in the leases. The capitalized values of depreciable assets are generally depreciated over the related lease terms in equal annual amounts. Costs of all other leases are charged against operations as incurred.

2. DEASE LAKE EXTENSION

These costs consist of charges relating to the uncompleted Dease Lake extension. Construction was suspended in 1977 and there are no commitments to continue. In the event any portion of this extension is abandoned, the cost less any value recovered will be written off at that time.

3. LONG-TERM DEBT

Long-term debt outstanding, less current maturities, consists of the following (in thousands):

	1988	1987
Sinking fund bonds and debentures payable to the Province of British Columbia (the Province)		
11% due June 1995	**$ 25,000**	$ 25,000
10.99% due August 2005	**24,490**	24,490
	49,490	49,490
Less sinking fund	**654**	416
	48,836	49,074
Bond payable to the Province		
10.75% due February 1990	**25,000**	25,000
Capital lease obligations — Notes 6 and 12	**39,390**	40,888
	113,226	114,962
Deduct current portion	**1,766**	1,596
	$111,460	$113,366

4. MINORITY INTEREST

The minority interest consists of 8,000,000 series 1-A first preferred shares with a par value of $25 each issued by BC Rail Ltd. These shares are designated as $2.3125 cumulative, redeemable and retractable.

BC Rail Ltd. must make all reasonable efforts in each quarter to purchase for cancellation in the open market three-quarters of 1% of the series 1-A preferred shares outstanding at the beginning of the quarter at a price not to exceed $25 per share and all transaction costs. If it is unable to fulfill its obligation in any calendar quarter the obligation will carry over only to the successive calendar quarters of the same calendar year and will thereafter be extinguished. During 1988 the company was unable to purchase shares at a price not exceeding $25 per share. On June 1, 1989, these shares are retractable at par at the option of the holder.

5. SHARE CAPITAL

Authorized

10,000,000 shares with a par value of $100 each.

Issued and outstanding

2,576,885 shares held by the Province

As all of the shares are held by the Province, earnings per share have not been provided.

6. COMMITMENTS

The company has significant lease commitments for rolling stock and additional minor lease commitments for equipment and real estate which expire at various dates prior to the year 2003. Certain of these leases transfer substantially all of the benefits and risks of ownership to the company and are accounted for as capital assets.

The following is a schedule of future minimum rental payments at December 31, 1988 required under non-cancellable leases that have remaining terms in excess of one year (in thousands):

	Capital leases	Operating leases
1989	**$ 6,763**	**$14,150**
1990	**6,763**	**12,752**
1991	**6,763**	**11,442**
1992	**6,763**	**10,213**
1993	**6,763**	**8,313**
Later years	**44,302**	**17,716**
Total minimum lease payments	**78,117**	**$74,586**
Less		
Executory costs	**5,773**	
Imputed interest	**32,954**	
Present value	**$39,390**	

Assets under capital leases recorded in the property and equipment accounts as at December 31, 1988 are as follows (in thousands):

Equipment	**$46,493**
Accumulated depreciation	**15,704**
	$30,789

As at December 31, 1988 the company had outstanding purchase commitments for the acquisition of land, material and equipment amounting to $20 million.

7. CONTINGENT LIABILITIES

The company is contingently liable with respect to pending litigation and claims arising in connection with construction and in the normal course of business. In the opinion of management any liability that may arise will be capitalized or would not have a material adverse effect on future income.

8. INCOME TAXES

The effective tax rate differs from the rate of 46.4% applicable to British Columbia companies because the net income of British Columbia Railway Company and BCR Properties Ltd. is exempt from federal and provincial income taxes; however, the net income of BC Rail Ltd. is subject to federal and provincial income taxes.

9. GOVERNMENT ASSISTANCE

Government assistance was as follows (in thousands):

	1988	1987
Unapplied, beginning of year	**$ 0**	$ 767
Contributions during the year		
From the Province		
Fort Nelson extension		
Operating	**4,150**	3,493
Rehabilitation	**8,330**	7,275
Passenger operation	**2,500**	2,500
Passenger car modernization	**1,597**	1,063
Flood control	**0**	(110)
	16,577	14,221
From the Government of Canada		
Grain transportation	**634**	3,240
	17,211	17,461
Total available	**17,211**	18,228
Applied as follows		
Revenue		
Grain transportation	**634**	3,240
Passenger operation	**2,500**	2,500
Fort Nelson extension	**4,150**	4,150
	7,284	9,890
Operating expenses		
Fort Nelson extension	**2,834**	2,932
Passenger car modernization	**1,597**	1,063
	4,431	3,995
Property and equipment		
Fort Nelson extension	**5,496**	4,343
Total applied	**17,211**	18,228
Unapplied, end of year	**$ 0**	$ 0

10. INTEREST EXPENSE

Interest expense was as follows (in thousands):

	1988	1987
Interest on long-term debt and notes to the Province	**$ 8,140**	$ 8,254
Less		
Sinking fund earnings	**49**	25
Interest earned on temporary investments	**1,734**	1,420
	1,783	1,445
	6,357	6,809
Interest on capital lease obligations	**4,788**	5,030
Net interest	**$11,145**	$11,839

11. PENSION PLAN

The company maintains a contributory defined benefit plan which covers substantially all of its employees. The plan provides pensions based on length of service and average earnings.

An actuarial valuation of the plan as at January 1, 1989 indicates that the accrued benefit obligations and the net assets available to provide for these obligations are as follows:

Accrued benefit obligations	$161 million
Pension fund assets	$195 million

A proposal will be presented in 1989 to the joint Pension Committee that will be designed to reduce the excess of pension fund assets over the accrued benefit obligations.

12. RELATED PARTY TRANSACTIONS

Related party information not presented elsewhere in the notes to financial statements is presented below.

First preferred shares of BC Rail Ltd. and certain capital lease obligations are guaranteed by the Province. The Ministry of Finance and Corporate Relations of the Province acts as fiscal agent and the Superannuation Commission of the Province administers the company pension plan. Fees are charged for both of these services.

Except as described in Note 8, the company is subject to all other taxes levied by the Province except property taxes. All other transactions between the company and the Province are at terms no more or less favorable than those with unrelated parties.

13. COMPARATIVE DATA

Where applicable, the 1987 accounts have been reclassified to conform with the 1988 presentation.

Five Year Review

CONSOLIDATED STATEMENT
(Dollars in Thousands)

	FISCAL YEAR				
	1988	1987	1986	1985	1984
Revenues					
Rail operations	**$319,710**	$315,707	$308,659	$295,916	$258,287
Government operating assistance	**7,284**	9,890	9,151	7,077	4,967
	326,994	325,597	317,810	302,993	263,254
Expenses					
Operations	**70,674**	71,216	67,928	67,424	57,028
Equipment	**66,580**	67,042	69,171	62,682	57,849
Road	**45,516**	48,117	43,274	38,468	33,693
Depreciation	**35,853**	34,870	32,359	30,425	26,520
Other	**24,086**	23,542	24,046	23,438	19,076
	242,709	244,787	236,778	222,437	194,166
Railway operating income	**84,285**	80,810	81,032	80,556	69,088
Non-operating income (expense)					
Interest	**(11,145)**	(11,839)	(13,687)	(18,442)	(46,990)
Debt servicing assistance	**—**	—	—	—	22,475
Other income	**3,676**	3,267	4,730	(351)	(543)
	(7,469)	(8,572)	(8,957)	(18,793)	(25,058)
Net income before deferred income taxes	**76,816**	72,238	72,075	61,763	44,030
Provision for (recovery of) deferred income taxes	**—**	(517)	2,138	333	1,343
Net income before minority interest	**76,816**	72,755	69,937	61,430	42,687
Minority interest	**18,500**	18,500	18,500	18,500	8,345
Net income	**$ 58,316**	$ 54,255	$ 51,437	$ 42,930	$ 34,342
OPERATING STATISTICS					
Total revenue cars loaded on line	**222,762**	229,506	232,367	232,115	197,643
Received from connections	**3,209**	3,656	3,330	2,220	2,614
Total carloadings	**225,971**	233,162	235,697	234,335	200,257
MOTIVE POWER					
Electric locomotives	**7**	7	7	7	7
Diesel locomotives	**116**	117	109	110	115
ROLLING STOCK FLEET					
Freight cars	**9,908**	10,107	10,146	9,960	10,060
Passenger cars	**9**	9	9	9	9
Boarding and work cars	**469**	449	455	452	469
TONS HAULED	**17,340,000**	17,670,000	17,854,000	17,832,000	14,672,000
EMPLOYEES AT YEAR END	**2,700**	2,760	2,660	2,620	2,640

Financial Review

British Columbia Railway Company

FINANCIAL SUMMARY

Consolidated net income for 1988 was $58.3 million, 7% higher than the previous year's $54.3 million. Revenues remained stable while expenses were reduced 1%, resulting in a $3.5 million (4%) increase in railway operating income.

REVENUES

Increases in woodchip, pulp, and coal revenues were offset by declines in lumber and other commodities. Twelve per cent of total revenue is derived from rent from equipment reflecting BC Rail's position as a feeder rail line, originating forest product carloads destined for eastern Canadian and US markets with resultant car-hire earnings while the cars are off-line.

EXPENSES

Operating expenses for the railway were $242.7 million for 1988 (1987 $244.8 million). Excluding depreciation, operating expenses decreased by $3.1 million, due to reduced hours worked, reduced car lease expense and reduced fuel prices which more than offset wage increases and continued inflation.

Fuel costs represent approximately 30% of annual Operations costs. In 1988 a reduced price per litre of diesel fuel and the results of several initiatives to optimize fuel consumption contributed to containing fuel costs. The introduction in recent years of yard "slugs", tractive power units used in conjunction with diesel electric locomotives, has assisted in reducing fuel usage. Changes in coal train operation early in the year reduced the total cost of electrical power.

1988 Equipment and Road maintenance expenses were favourably impacted by efficiencies gained through recent capital expenditures. Locomotive, rail car, and track maintenance activities continue to be completed on a "programmed" basis, utilizing specific shops and track crews for efficiency. Mishap costs in 1988 were below 1987 levels.

OPERATING RATIO

The company's operating ratio, the ratio of operating expenses including depreciation to revenue, improved in 1988 to .74 (1987 - .75).

NON OPERATING ITEMS

Interest expense was reduced by 6% or $.7 million as a result of the company's improved cash position. The company has reduced long-term debt by $84.8 million since December 31, 1984.

During 1988, as in 1987, dividends of $18.5 million were paid by BC Rail Ltd. on the series 1-A first preferred shares issued. These cumulative shares, with a par value of $25 each, pay dividends of $2.3125 annually per share.

In 1988 British Columbia Railway Company paid its sole shareholder, the Province of British Columbia, a dividend of $10.3 million on its common shares. This is the third successive year that a dividend of this amount has been paid.

BC Rail Ltd.

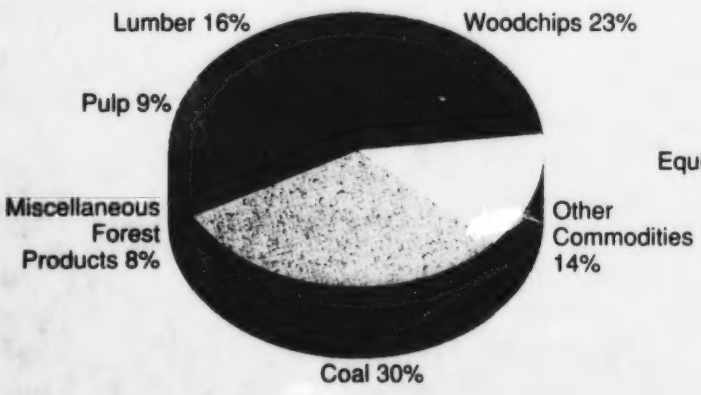
BC Rail Ltd. is the railway operating subsidiary of the British Columbia Railway group. These additional comments relate to BC Rail Ltd. only.

FINANCIAL SUMMARY

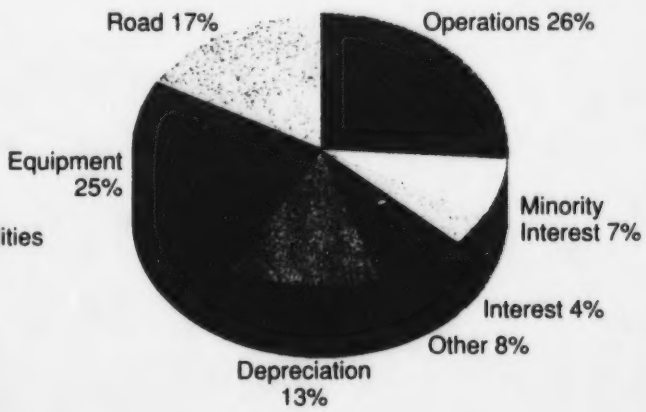
The $3.5 million improvement in railway operating income in 1988 was offset by a $5.2 million increase in interest expense, resulting in a net loss for 1988 of $3.9 million (1987 - $1.4 million).

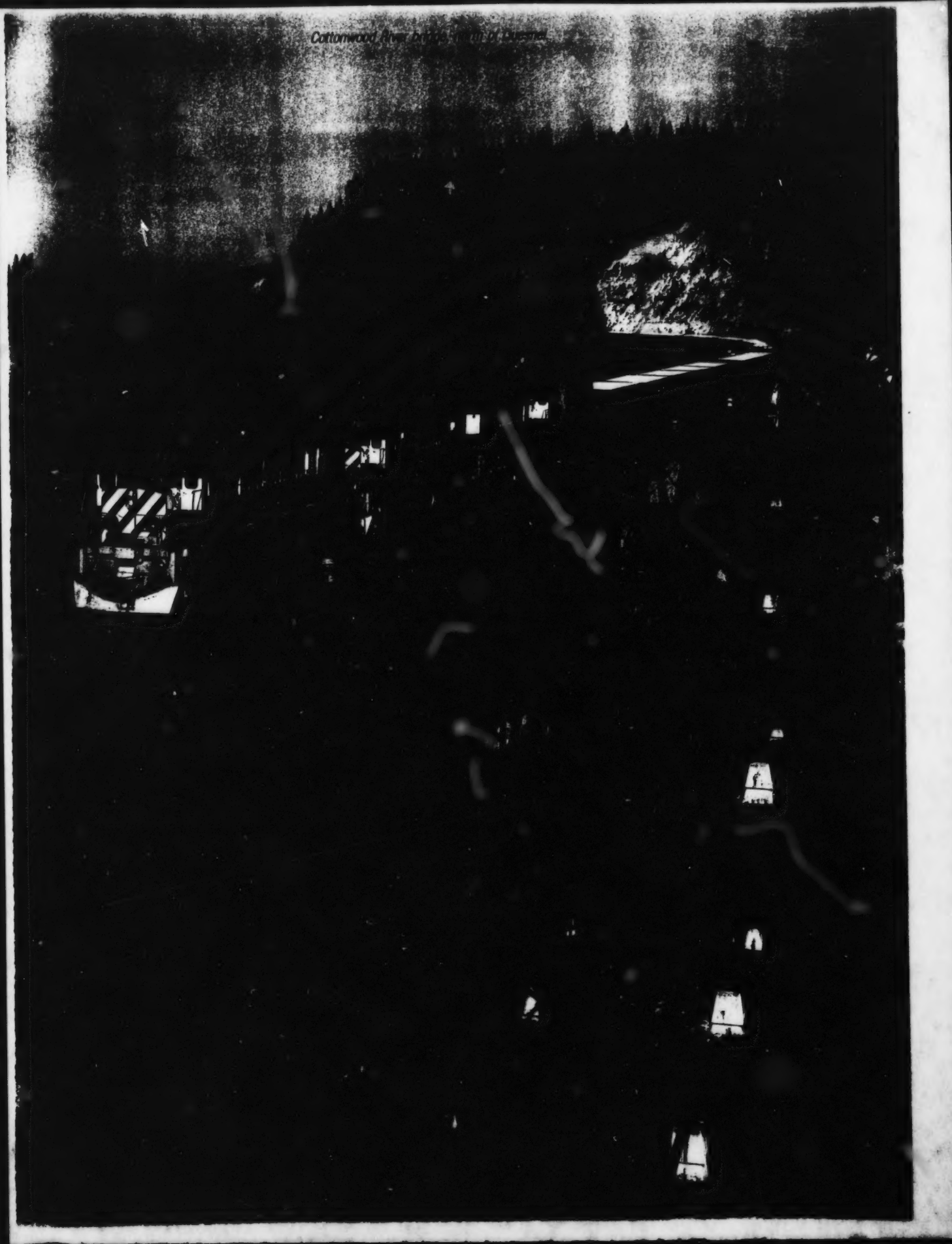
Interest expense increased 6% to $89.9 million (1987 - $84.7 million). Interest on notes payable to related companies increased by $1.2 million to $90.4 million in 1988 while interest income, mostly from related companies, dropped to $5.3 million (1987 - $9.5 million).

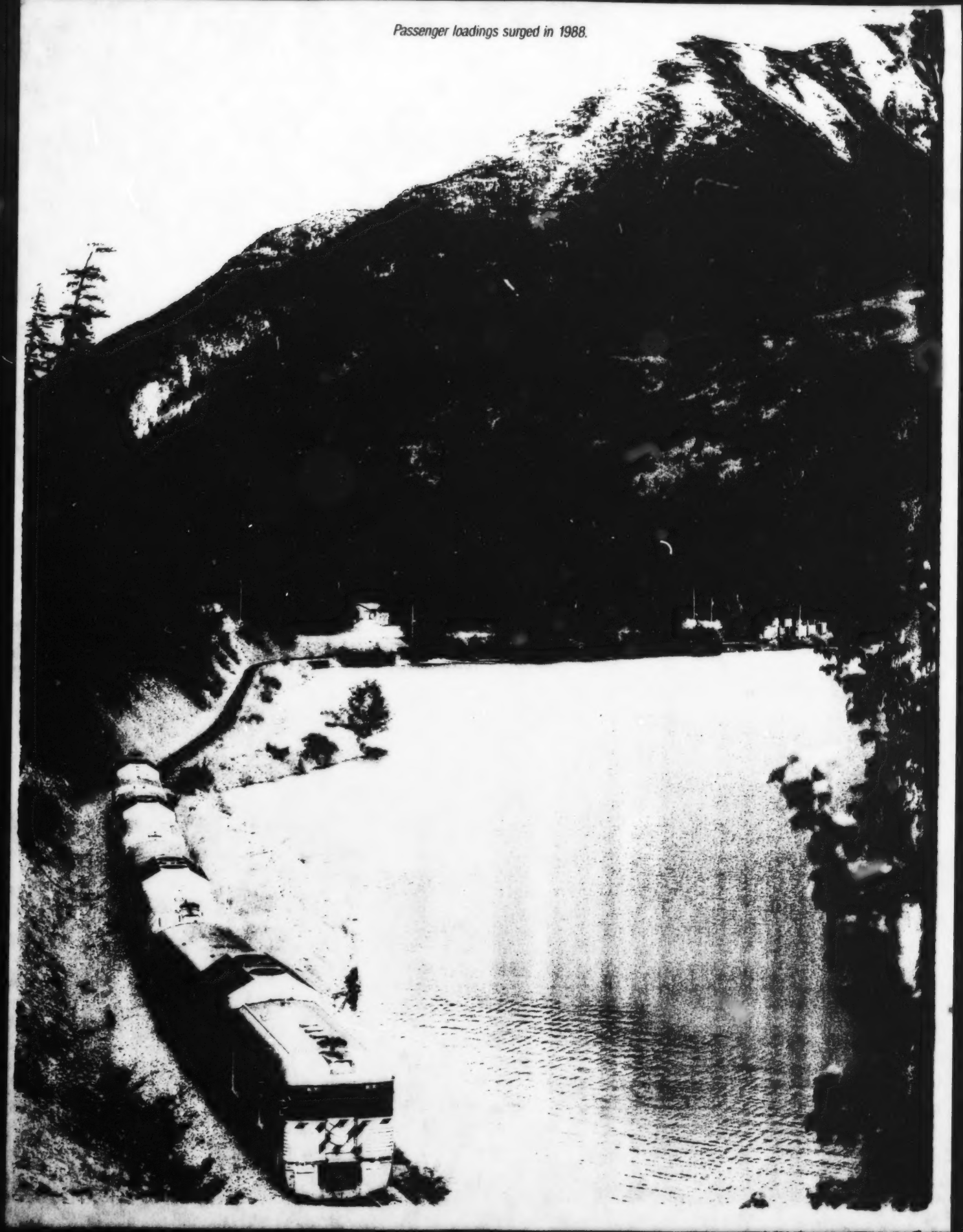
Carloadings



Consolidated Expenses







Passenger loadings surged in 1988.

BC Rail Ltd.
Financial Statements

BC Rail Ltd. Report of Management

The accompanying financial statements of BC Rail Ltd. and all other information contained in the Annual Report are the responsibility of management. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances in a manner consistent with the previous year and, accordingly, include some amounts based on management's best judgements and estimates. The financial information contained elsewhere in this Annual Report is consistent with that in the financial statements.

Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance, at an appropriate cost/benefit relationship, that assets are safeguarded and that transactions are authorized, recorded and reported properly. The internal accounting control system is augmented by a program of internal audits and appropriate reviews by management, written policies and guidelines and a written Code of Business Conduct adopted by the Board of Directors, applicable to all employees of the company. Management believes that the company's internal accounting controls provide reasonable assurance that assets are safeguarded against material loss from unauthorized use or disposition and that the financial records are reliable for preparing financial statements and other data and maintaining accountability for assets.

The Audit and Finance Committee of the Board of Directors, composed solely of directors who are not officers of the company, meets with the independent auditors, management and internal auditors periodically to discuss internal accounting controls, auditing and financial reporting matters. The committee reviews with the independent auditors the scope and results of the audit effort. The committee also meets with the independent auditors without management present to ensure that the independent auditors have free access to the committee. The committee reviews the annual financial statements and recommends their approval by the Board of Directors.

The independent auditors, Coopers & Lybrand, are appointed by the shareholders to examine the financial statements of BC Rail Ltd. and conduct such tests and related procedures as they deem necessary in conformity with generally accepted auditing standards. The opinion of the independent auditors, based upon their examination of the financial statements, is contained in this Annual Report.

M. C. Norris,
President and Chief Executive Officer

J. R. Clarke,
Vice-President,
Finance & Administration

Auditors' Report

To the Shareholders

We have examined the balance sheet of BC Rail Ltd. as at December 31, 1988 and the statements of loss and deficit, contributed surplus and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1988 and the results of its operations and the changes in its cash position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Coopers & Lybrand

Vancouver, Canada
February 9, 1989

BC Rail Ltd. Loss and Deficit

(Dollars in Thousands)

For the year ended December 31	1988	1987
Revenues		
Rail operations	**$319,710**	$315,707
Government operating assistance — Note 8	**7,284**	9,890
	326,994	325,597
Expenses		
Operations	**70,674**	71,216
Equipment	**66,580**	67,042
Road	**45,516**	48,117
Depreciation	**35,853**	34,870
General and administration	**24,086**	23,542
	242,709	244,787
Railway operating income	**84,285**	80,810
Non-operating income (expense)		
Interest — Note 9	**(89,889)**	(84,715)
Other income	**1,720**	1,993
Net loss before deferred income taxes	**3,884**	1,912
Recovery of deferred income taxes	**0**	517
Net loss	**3,884**	1,395
Deficit (retained earnings), beginning of year	**1,065**	(330)
Deficit, end of year	**$ 4,949**	$ 1,065

BC Rail Ltd. Contributed Surplus

(Dollars in Thousands)

For the year ended December 31	1988	1987
Balance, beginning of year	**$72,155**	$92,655
Dividends paid		
Preferred shares	**18,500**	18,500
Common shares	**2,000**	2,000
	20,500	20,500
Balance, end of year	**$51,655**	$72,155

BC Rail Ltd.
Balance Sheet
(Dollars in Thousands)

December 31	1988	1987
Assets		
Current assets		
Cash	**$ 22,693**	$ 23,447
Accounts receivable	**38,441**	37,131
Material and other items	**33,723**	35,580
	94,857	96,158
Property and equipment		
Road and buildings	**1,177,200**	1,119,902
Equipment	**271,636**	269,943
	1,448,836	1,389,845
Accumulated depreciation	**308,535**	278,099
	1,140,301	1,111,746
Dease Lake extension — Note 2	**98,020**	98,020
	$1,333,178	$1,305,924
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	**$ 78,199**	$ 97,279
Current obligations on long-term debt	**1,574**	1,404
Due to (from) related companies	**56,895**	(44,025)
	136,668	54,658
Long-term debt — Note 3	**738,114**	768,486
Shareholders' equity		
Share capital — Note 4	**411,690**	411,690
Contributed surplus	**51,655**	72,155
Deficit	**(4,949)**	(1,065)
	458,396	482,780
Commitments — Note 5		
Contingent liabilities — Note 6		
	$1,333,178	$1,305,924

On behalf of the Board

E. Beverly Ellis, *Director*

M.C. Norris, *Director*

BC Rail Ltd.
Cash Flow
(Dollars in Thousands)

For the year ended December 31	1988	1987
Operating activities		
Net loss	**$ (3,884)**	$ (1,395)
Add (deduct)		
Items not affecting working capital		
Depreciation	**35,853**	34,870
Deferred income taxes (recovery)	**0**	(517)
Net changes in non-cash working capital		
Accounts receivable	**(1,310)**	13,496
Material and other items	**1,857**	(5,214)
Accounts payable	**(18,535)**	16,203
Related company accounts	**100,920**	(14,549)
Interest	**89,889**	84,715
	204,790	127,609
Investing activities		
Additions to property and equipment	**(69,904)**	(70,852)
Change in payables for equipment purchases	**(545)**	(146)
Government assistance for capital items	**5,496**	4,343
	(64,953)	(66,655)
Financing activities		
Issue of long-term debt	**0**	68,245
Repayment of long-term debt	**(30,202)**	(1,249)
Interest	**(89,889)**	(84,715)
	(120,091)	(17,719)
Dividends paid	**(20,500)**	(20,500)
Increase (decrease) in cash	**(754)**	22,735
Cash, beginning of year	**23,447**	712
Cash, end of year	**$ 22,693**	$ 23,447

BC Rail Ltd.
Notes to Financial Statements

1. SIGNIFICANT ACCOUNTING POLICIES

The accounting regulations prescribed by the Canadian Transport Commission for Canadian railways have been adopted to the extent that this is possible without submitting specific accounting policies and depreciation rates to the Commission for approval.

Class of business

The company provides a fully integrated rail freight service within British Columbia. Services other than hauling freight are not of sufficient size to warrant separate reporting.

Road property

New construction is recorded at cost net of Government grants. Abandoned or relocated sections are removed at average unit costs. Elements of track structure installed during planned programs are recorded at cost and the material replaced is removed at amounts which approximate average unit costs. Labour costs for programmed replacements are expensed as incurred.

Depreciation

Depreciation is provided for major categories of property and equipment on the straight-line basis at composite rates estimated to reduce the original cost to estimated salvage value over the average service lives of the classes. The group method is used for recording depreciation under which, on disposal, the original cost of assets retired less salvage value is charged against accumulated depreciation. No gain or loss on retirements, other than on accidental destruction of rolling stock and on disposal of land, is included in income. The original cost of assets less estimated salvage value is depreciated over the following number of years:

	Number of years
Grade and tunnels	100
Rail	35
Ties	15
Ballast	25
Bridges	30-80
Locomotives and power units	25
Freight cars	15-33

Repairs

Repairs and non-programmed replacements of track structure are charged against current operations. Betterments and major track relocations are capitalized.

Material and supplies

Inventories of material and supplies are valued at the lower of average cost and net realizable value.

Government assistance

Grants directly related to the construction or rehabilitation of road property have offset related road property capital expenditures. Operating assistance has been deducted from the related expense accounts or included in revenue.

Income taxes

Income tax expense is computed on the basis of accounting income recorded by the company.

Transactions in foreign currency

Transactions originating in foreign currency are translated at the approximate exchange rates prevailing at the dates of the transactions. Assets and liabilities denominated in foreign currency at the balance sheet date are translated to equivalent Canadian amounts at the current rate of exchange.

Leases

Certain long-term lease transactions relating to the financing of equipment are accounted for as purchases. The capital lease obligations reflect the present value of future minimum rental payments discounted at the interest rate implicit in the leases. The capitalized values of depreciable assets are generally depreciated over the related lease terms in equal annual amounts. Costs of all other leases are charged against operations as incurred.

2. DEASE LAKE EXTENSION

These costs consist of charges relating to the uncompleted Dease Lake extension. Construction was suspended in 1977 and there are no commitments to continue. In the event any portion of this extension is abandoned, the cost less any value recovered will be written off at that time.

3. LONG-TERM DEBT

Long-term debt outstanding, less current maturities, consists of the following (in thousands):

	1988	1987
Capital lease obligations —		
Notes 5 and 10	$ 39,390	$ 40,888
Deduct current portion	1,574	1,404
	37,816	39,484
Notes payable to the British Columbia Railway Company		
10.75% due February 1990	25,000	25,000
10.4% due June 1995	56,350	56,350
12.75% due July 1995	85,993	114,697
9.7% due June 1991	62,210	62,210
9.96% due June 1992	68,245	68,245
	297,798	326,502
Notes payable to BCR Properties Ltd.		
14% due June 1999	402,500	402,500
	$738,114	$768,486

4. SHARE CAPITAL

Authorized

5,000,000 common shares with a par value of $100 each.

20,000,000 first preferred shares with a par value of $25 each of which 8,000,000 are designated as $2.3125 cumulative redeemable retractable first preferred shares, series 1-A.

20,000,000 second preferred shares with a par value of $100 each of which 3,000,000 have been designated as non-cumulative redeemable second preferred shares, series 2-A.

Issued and outstanding ($ in thousands):

500,012 common shares	$ 50,001
8,000,000 series 1-A preferred shares	200,000
1,616,892 series 2-A preferred shares	161,689
	$411,690

As all of the common shares are held by British Columbia Railway Company and its wholly owned subsidiary, earnings per share have not been provided.

The company must make all reasonable efforts in each quarter to purchase for cancellation in the open market three-quarters of 1% of the series 1-A preferred shares outstanding at the beginning of the quarter at a price not to exceed $25 per share and all transaction costs. If it is unable to fulfill its obligation in any calendar quarter the obligation will carry over only to the successive calendar quarters of the same calendar year and will thereafter be extinguished. During 1988 the company was unable to purchase shares at a price not exceeding $25 per share. On June 1, 1989, these shares are retractable at par at the option of the holder.

5. COMMITMENTS

The company has significant lease commitments for rolling stock and additional minor lease commitments for equipment and real estate which expire at various dates prior to the year 2003. Certain of these leases transfer substantially all of the benefits and risks of ownership to the company and are accounted for as capital assets.

The following is a schedule of future minimum rental payments at December 31, 1988 required under non-cancellable leases that have remaining terms in excess of one year (in thousands):

	Capital leases	Operating leases
1989	$ 6,763	$14,150
1990	6,763	12,752
1991	6,763	11,442
1992	6,763	10,213
1993	6,763	8,313
Later years	44,302	17,716
Total minimum lease payments	78,117	$74,586
Less		
Executory costs	5,773	
Imputed interest	32,954	
Present value	$39,390	

Assets under capital leases recorded in the property and equipment accounts as at December 31, 1988 are as follows (in thousands):

Equipment	$46,493
Accumulated depreciation	15,704
	$30,789

As at December 31, 1988 the company had outstanding purchase commitments for the acquisition of land, material and equipment amounting to $20 million.

6. CONTINGENT LIABILITIES

The company is contingently liable with respect to pending litigation and claims arising in connection with construction and in the normal course of business. In the opinion of management any liability that may arise will be capitalized or would not have a material adverse effect on future income.

7. PENSION PLAN

The company maintains a contributory defined benefit plan which covers substantially all of its employees. The plan provides pensions based on length of service and average earnings.

An actuarial valuation of the plan as at January 1, 1989 indicates that the accrued benefit obligations and the net assets available to provide for these obligations are as follows:

Accrued benefit obligations	$161 million
Pension fund assets	$195 million

A proposal will be presented in 1989 to the joint Pension Committee that will be designed to reduce the excess of pension fund assets over the accrued pension obligations.

8. GOVERNMENT ASSISTANCE

Government assistance was as follows (in thousands):

	1988	1987
Unapplied, beginning of year	$ 0	$ 767
Contributions during the year		
From the Province		
Fort Nelson extension		
Operating	4,150	3,493
Rehabilitation	8,330	7,275
Passenger operation	2,500	2,500
Passenger car modernization	1,597	1,063
Flood control	0	(110)
	16,577	14,221
From the Government of Canada		
Grain transportation	634	3,240
	17,211	17,461
Total available	17,211	18,228
Applied as follows		
Revenue		
Grain transportation	634	3,240
Passenger operation	2,500	2,500
Fort Nelson extension	4,150	4,150
	7,284	9,890
Operating expenses		
Fort Nelson extension	2,834	2,932
Passenger car modernization	1,597	1,063
	4,431	3,995
Property and equipment		
Fort Nelson extension	5,496	4,343
Total applied	17,211	18,228
Unapplied, end of year	$ 0	$ 0

9. INTEREST EXPENSE

Interest expense was as follows (in thousands):

	1988	1987
Interest on notes payable		
BCR Properties Ltd.	$56,350	$56,350
British Columbia Railway Company	34,048	32,838
	90,398	89,188
Interest on capital lease obligations	4,788	5,030
	95,186	94,218
Less interest income		
Related companies	3,563	8,082
Other	1,734	1,421
	5,297	9,503
Net interest	$89,889	$84,715

10. RELATED PARTY TRANSACTIONS

Related party information not presented elsewhere in the notes to financial statements is presented below.

All of the outstanding common and second preferred shares of the company are owned as follows:

BCR Properties Ltd. (a wholly-owned subsidiary of British Columbia Railway Company)	75%
British Columbia Railway Company	25%

First preferred shares and certain capital lease obligations are guaranteed by the Province. The Ministry of Finance and Corporate Relations of the Province acts as fiscal agent and the Superannuation Commission of the Province administers the company pension plan. Fees are charged for both of these services.

The company is subject to all other taxes levied by the Province except property taxes. All other transactions between the company and the Province are at terms no more or less favorable than those with unrelated parties.

11. COMPARATIVE DATA

Where applicable, the 1987 accounts have been reclassified to conform with the 1988 presentation.

The Post McKenzie Years

In December, 1976, when the B.C. provincial government announced a Royal Commission of Inquiry into the affairs of British Columbia Railway Company, the news was not enthusiastically received by management.

By that time, the company's first ever, non-political professional managers had already made headway in installing financial controls, upgrading trackage and physical plant and in improving the railway's sorry record of safety and labour relations.

The news then, that the company was to be held up to public scrutiny for the third time in its history — despite all that had been achieved by the existing management group — came as a severe shock to those most closely concerned.

"We'd done so much since 1974 ... and with all that to show, we were still going to be put on trial. We felt the commissioners were bound to be biased."

(M. C. Norris, President & CEO, 1987)

With the wisdom of hindsight, however, it became evident that Mr. Justice Lloyd McKenzie's Royal Commission was a watershed —

First coal train, November 1, 1983.

and that more than any other event in the railway's troubled, 66-year existence, to that date, the Commission's main findings were the keystone upon which the successful enterprise of today has been built.

The Commission's principal recommendations called for the railway to 'cease its pioneering role' and to commence operating in accordance with sound business principles. For almost its entire existence, the railway had been regarded by its political masters as a developmental enterprise, its main purpose to build lines in advance of need — with no immediate concern for recovery of costs — in the hope that economic development would follow.

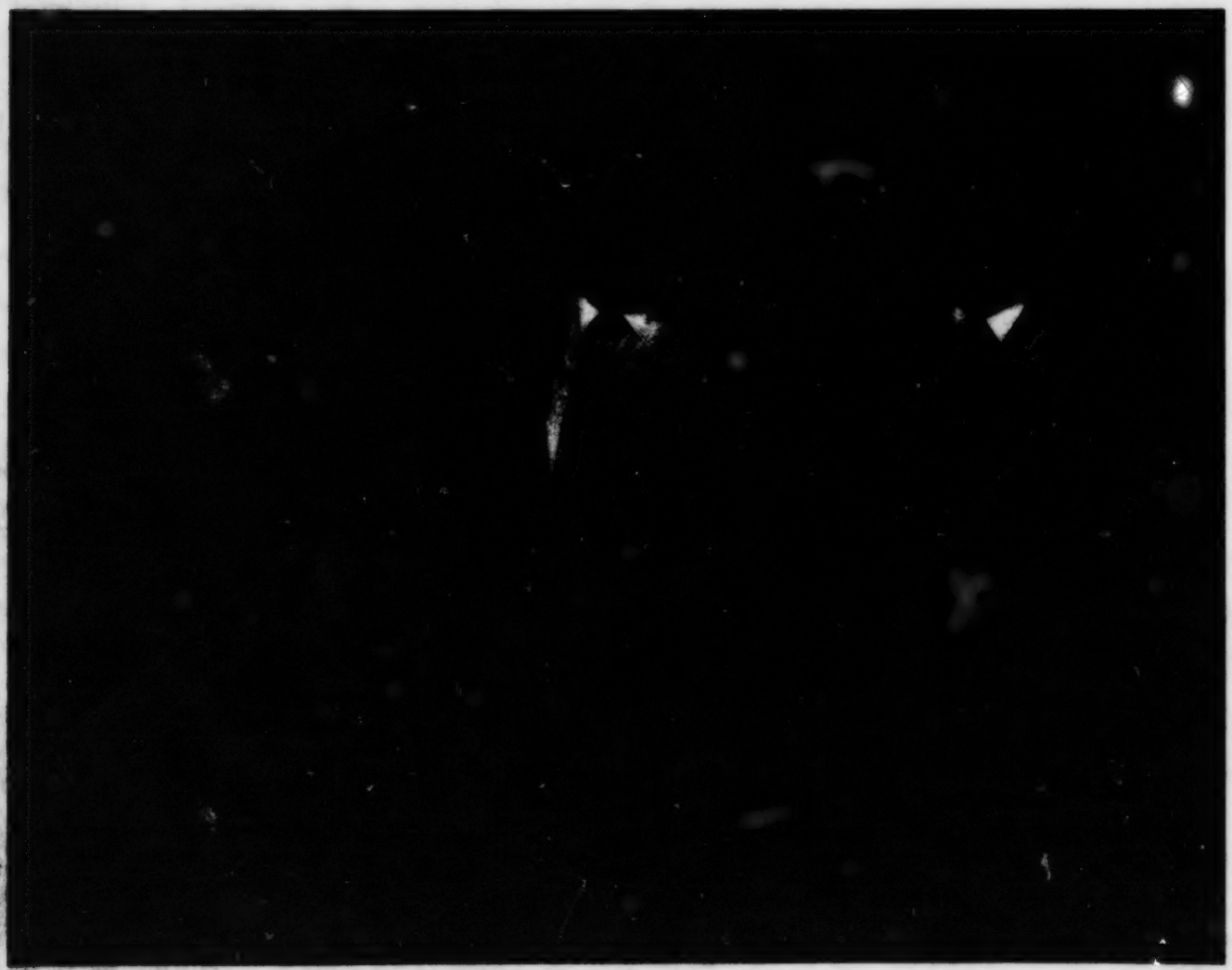
Towards development of the sound business principles urged by Mr. Justice McKenzie, the original senior management team chosen by then (1975) Vice-President M. C. (Mac) Norris, was strengthened by the appointment of J. R. (Roger) Clarke as Chief Financial Officer, under whose direction the company's fiscal policy and controls have largely evolved.

Following Mr. Norris's 1978 appointment to the position of President and Chief Executive Officer, A. C. (Arnold) Sturgeon, G. L. (Gordon) Ritchie, the late N. A. (Norman) McPherson and Mr. Clarke were raised to the positions of Vice-Presidents Marketing and Sales; Administration; Operations and Maintenance and Finance respectively.

With a strong executive management group — augmented later by the 1980 appointment of the late P. A. (Archie) MacDonald as Vice-President — Industrial Relations — the 'new' British Columbia Railway was set to carry out its mandate in a climate purportedly free of political interference.

In the interim, the massive task of rebuilding and modernizing the railway's aging physical plant continued — its progress hampered, however, by the need for the railway's new management to service $750 million of debt. Largely incurred in the construction of the 'developmental' Dease Lake and Fort Nelson extensions — the debt and its debilitating interest charges tended to mask the company's improving operational performance.

Nevertheless, record losses of $58.3 million



in 1977 steadily dwindled over the next few years and by 1982, a year of deep economic recession in B.C., the railway had recovered sufficiently, with the assistance of debt-servicing grants from the province, to declare record net income of $18.6 million. As well as testifying to the effectiveness of greatly improved fiscal controls, the result demonstrated that the company's huge investments in modernization and renewal were beginning to bear fruit.

"...we recommend that it (British Columbia Railway) be made a genuinely autonomous Crown corporation... accountable to a minister but without political representation on its board."

(Justice Lloyd McKenzie, 1978)

Five years earlier, prospects were much less encouraging. In 1978, negotiations between mining companies, bankers, governments and Japanese customers were already under way for the development of northeastern B.C.'s huge metallurgical and thermal coal deposits.

In view of its performance to 1977, however, the likelihood of British Columbia Railway being entrusted with construction of a needed, 81-mile rail link seemed slim indeed. In a way, management's fight to convince government that the company had the systems, financial acumen, plant and people to make it happen was the 'new' railway's first act of faith.

Few outsiders really believed it possible. But not surprisingly, the critics and detractors were silent on November 1st, 1983. On that day, after just 32 months of construction, the first trainload of Japan-bound coal rolled slowly out of Tumbler — a month ahead of schedule.

The finished Tumbler Ridge line, a $500 million showcase of the most modern rail technology of its time, was a railroader's dream. One of only three 50 kilovolt electrified lines in the world, its non-stop construction involved four Rocky Mountain tunnels — one six miles, another four miles long — and an army of skilled railway builders from around the world.

Incredibly, the decision to electrify was not taken until April, 1982. Only after three meetings with senior management was the railway's independent board of directors convinced that electrification — for a variety of operational and financial reasons — was the safest, most efficient and most economical alternative to the overheating, oxygen starvation and fume build-up of diesel locomotives in the long tunnels.

Construction of 'the Tumbler Sub' was initially financed by short-term borrowings. In the spirit of the McKenzie commission recommendations, construction costs were to have been the responsibility of the provincial government, which was to be reimbursed by means of a transportation surcharge applied to each ton of coal shipped.

In the event, the government chose instead to provide for defeasance of the company's $750 million of historic debt. The government later assigned responsibility for the balance of construction costs — as well as the transportation surcharges — to the railway.

In June, 1984, the company was financially restructured and at the same time, $200 million of preferred shares were issued by the new railway operating company, BC Rail Ltd., on Canadian stock exchanges. With a dividend rate at 9.25 per cent, the redeemable, retractable shares provided investors an attractive rate of return and they were quickly snapped up. The funds raised were used to reduce short term, Tumbler Ridge construction debt, upon which the railway was then paying 13 to 14 per cent interest.

"You have to be a railroader to appreciate it, I guess. Beautiful ballast, continuous welded rail — it's the ultimate in railroading."

(Vic Machetti — BC Rail employee, Dawson Creek).

Under the new organization, BC Rail Ltd. became a taxable Canadian corporation, 25 per cent owned by the British Columbia Railway Company (BCRC) and 75 per cent owned by a wholly-owned subsidiary of BCRC, BCR

Facing page — the original management team: President and Chief Executive Officer Mac Norris, left; Senior Vice-President Arnold Sturgeon, centre and former Vice-President and Secretary Gordon Ritchie, retired. This page: Vice-President Industrial Relations and Information Systems Brian Foley, left and Vice-President Finance and Administration Roger Clarke.

Properties Ltd. The sole common shareholder of BCRC is the Province of British Columbia.

Little more than a year earlier, construction of the company's new $18 million headquarters in North Vancouver had been completed and in March, 1983, nine former locations were consolidated, for the first time in the railway's history, in a single building. The company acted as developer and owns the building outright.

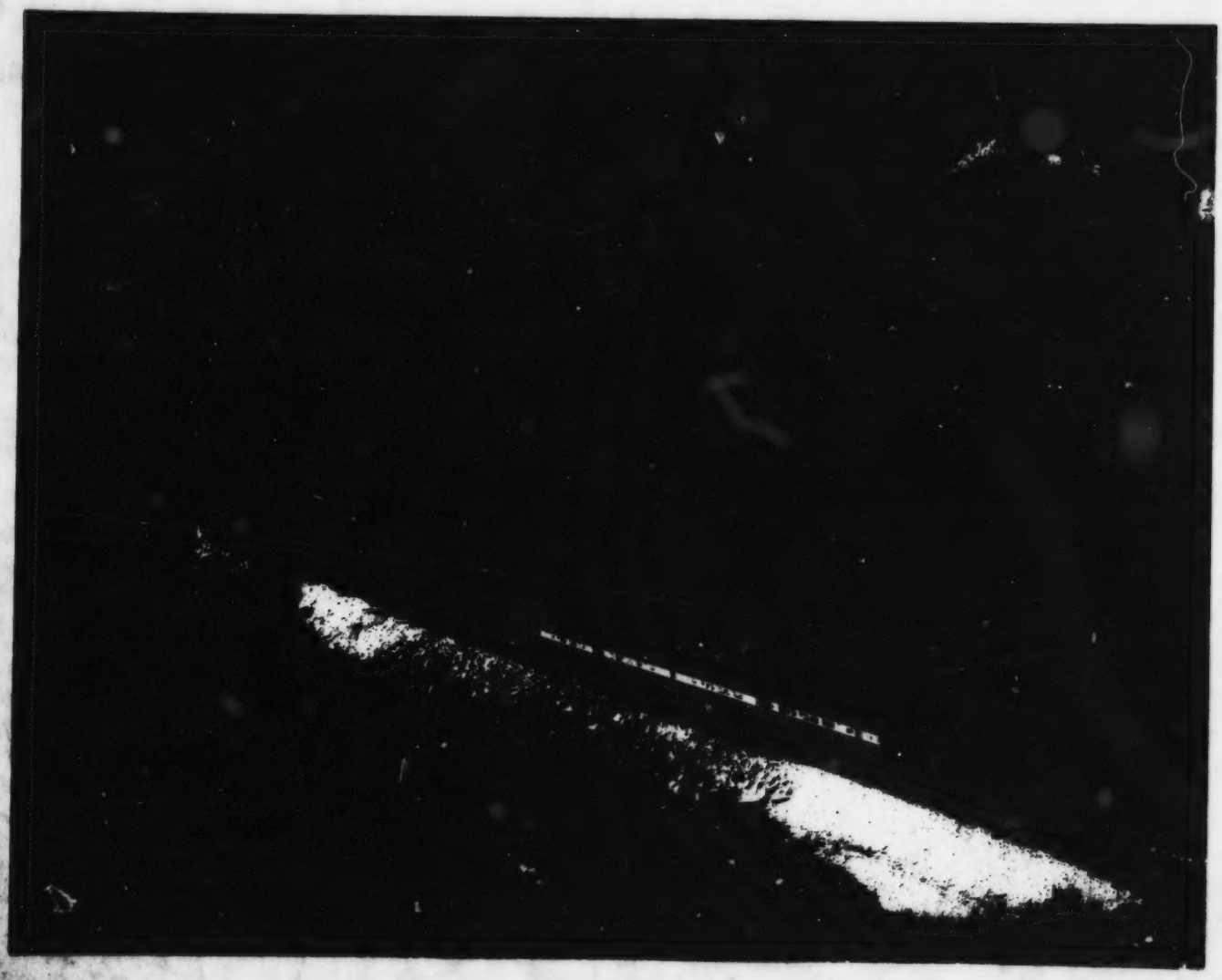
As well as locomotive and rolling stock renewal programs, major construction and improvement projects have been taking place throughout the system. New passenger stations have been built in Lillooet and Exeter and during the last few years, new locomotive, car repair, yard office and stores facilities have been opened in Prince George.

In 1983, the BCRC group acquired the former B.C. Harbours Board Railway, a 23-mile line linking B.C.'s southeastern coalfields with the Roberts Bank deep-sea coal port in Delta, B.C. The Port Subdivision, as the line is now known, is owned, maintained and dispatched by BC Rail, while the coal-carrying trains are owned and operated by other railways.

In the decade since Mr. Justice Lloyd McKenzie's findings became public, many other improvements have been made and many would agree that the ailing, beleaguered railway of the early 1970s has been transformed into a vital and efficient part of the North American railway system.

There is little doubt that the pre-McKenzie years were desperate times, demanding desperate measures. That the post-McKenzie years brought success, recognition and respect is a tribute to the skill and determination of a strong management team and a united workforce. It is no less a tribute to a series of independently thinking business-minded directors and to political masters who essentially have allowed the management to manage with minimal intervention.

Tumbler Ridge five years on.



Shalalth tunnel hole-through.

Notice of Special Meeting

For Non-voting Preferred Shareholders

The Board of Directors and Management of BC Rail Ltd. cordially invite preferred shareholders to an informational meeting on June 13th, 1989. The meeting will start at 10:30 a.m. and be held in the Stanley Park Room of the Westin Bayshore Hotel, Vancouver, B.C.

The meeting is not a legal requirement and it is offered as a courtesy to the company's preferred shareholders. Its purpose is to report on company activities and performance during 1988 and on the outlook for the current operational year. The informational meeting is open to the general public. It follows the company's Annual General Meeting, which is open only to common shareholders, directors and officers of the company.

For further information, please call:

Ms. C. A. Lee
(604) 984-5291

Contact Information

If you would like more copies of this report or additional information about the British Columbia Railway Group of companies, please call or write:

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